Corporate Trust Insights Series: CLO Industry Trends

TRANSCRIPT

MAGNUS WILSON-WEBB: Thank you for taking the time to join us today. As we start a new year, we'd like to recap on activities in the CLO space in 2020 and also look forward into 2021. As part of this session, we're going to cover both market and regulatory developments, but also touch on some of the enhancements BNY Mellon has been making in the digital space to better support the loan product. I'm joined today by three colleagues: Catriona Coyne, who's one of our product managers; Bruce Boyd, in our transaction management group, who's been in the CLO space since it first started; and Joe Coudriet, who's our loan market digital lead.

CATRIONA COYNE: Hi, my name is Catriona Coyne, and I'm the principal product manager covering loans here at BNY Mellon. Today, I'm going to give a brief overview looking at the CLO market in 2020 and looking forward into 2021.

So when we look back at 2020, the overriding theme is resiliency. The COVID-19 impact on the market was very significant in March and April. The CLOs in the market would generally bounce back very quickly. CLOs as an asset class come with proven credentials and have, as expected, performed very well. The structure was tested this year and has proved that it's structurally sound and built to withstand periods of stress.

During the 2008 financial crisis, rating agencies were slow in downgrading assets. During the 2020 pandemic, some can argue that rating agencies were too quick to downgrade. CLOs were resilient, even with the quick downgrade. However, I think we could have seen a very different landscape in the first few months of the year had they not downgraded so early. These downgrades back in March and April resulted in the spike in triple C buckets and had a knock-on impact on OC tests as well as failing WARF tests. However, the expected number of defaults has not materialized, and we're utilizing self-repair mechanisms and asset managers were, in most cases, able to clear these tests with very limited impact to senior note holders or executive distribution.

In Europe, there were very few senior OC test breaches overall, and equity cash flow disruptions peaked at just 4% of deals back in July. U.S. markets, which had begun the year with somewhat weaker portfolios overall, saw higher numbers of failing of OC tests, peaking in July around 20%. However, according to Citi, this number has reduced down to 7.7% of junior of OC-test failing by the end of the year. While further downgrades are expected over the course of 2021. CLO managers generally are optimistic that the worst is over and that the risk has already been factored in.

Overall issuance in 2020 was surprisingly good. European issuance totaled $22 billion in 66 deals with 43 managers issuing. Early activity was made up of issuance of pre-COVID warehouses, which was smaller CLOs with lower leverage and short-term non-call in the investment period. U.S. issuance, in part due to their busiest December on record, where we saw 27 deals issued, closed out the year at $93 billion across 218 deals based on 96 managers issuing, including five first-time managers.

So, what are the key trends that we saw in 2020? There's been some talk of a CLO 3.0, but many the changes that we saw in 2020, such as smaller deals and shorter reinvestment periods that were really symptoms of the COVID impact, and we already saw them being reversed if we look at deals issued toward the end of the year. One hotly debated topic and one which we expected to remain a feature in CLO documentation going forward is the language allowing CLOs to participate in workouts or loss mitigation loans. Bruce Boyd, our senior transaction manager, will cover this topic later on.

Another area where we saw a lot of developments over the course of the year was regulation. In the U.S., the biggest regulatory change, and one which was good news for the CLO markets, was the loosening of the Volcker Rule. This clarification around ownership interests and the introduction of safe harbor for certain debt interests means that banks are no longer penalized for investing in CLOs, and this further broadens the CLO investor market. The introduction of the 5% bond bucket, which is similar to what we have in Europe, also allows managers to invest and look for value in the bond market, so it remains to be seen how this will play out over the course of the year. In Europe, we saw the implementation of the long-awaited European Securitization, or ESMA, transparency disclosure requirements. These went live back in September 2020. This is a new regulatory requirement for all securitizations which have issued since the 1st of January 2019. CLOs need to provide two templates on a quarterly basis. First is Annex 4, which is detail on underlying assets in the portfolio, and the second is Annex 12, which is detail on the payment date of investor reporting.

All CLOs which issued since January are in scope of this, and we've also seen some loan funds fall into scope. Any CLOs which we finance after this date will also fall into scope, and we expect to see a lot more activity in this area over the course of 2021. The CLO market has done a lot of work in advance with managers, law firms and service providers coming together and reaching general consensus on a field-by-field basis of the interpretation of each of the data fields. BNY Mellon also organized a number of service provider sessions to assist with this consistency across the market. This meant that, while the first reporting period was still challenging, it was implemented with a far smoother transition than was originally expected. We're now gearing up for the second reporting cycle, which we expect to be smoother as the market becomes more familiar with the reporting requirements. We're also expecting to start to get some feedback from regulators over the course of this year. These new regulatory requirements are designed to increase transparency in the market, an area of increasing focus over the past number of years. Joe Coudriet, our loan market digital lead, will speak about the work we're planning to do to address data later on.

Now, looking forward to what we expect to see over the course of 2021. As Fitch noted at the recent conference, 2021 is likely to be a year of two halves, driven by the rollout and the viability of the vaccine and how this will allow governments to roll back lockdown measures. Fitch has advised the forecast upwards based on two key assumptions, which we saw play out in 2020.

The first is the reopening premium, that is, the strong boost of economic activity once lockdowns are eased or removed. The second is that policy support will continue and phasing out won't begin until later this year or even going into 2022. Recoveries and performance will be sector-driven with some industries taking longer to recover. As noted regularly, credit picking by managers continues to be of extreme importance with a focus on corporates who not only have liquidity now, but who will be able to maintain that liquidity over the course of this year and who have a strong business plan going forward.

Outlook for CLOs is positive, both in terms of investor demand as CLOs continue to perform and continue to provide good relative value versus other asset classes, and also in terms of loan supply. Both markets have begun the year with strong loan pipelines, but there are some differences in opinion as to how long this supply will remain strong, and also what impact the expected loan pricing will have on CLO arbitrage. Typically, the CLO market doesn't begin to ramp up until the second half of January, or even later in Europe, and this year is no different. As of the 18th of January, we've seen one static CLO in the U.S. with no issuance to date in Europe. Overall, new issuance forecasts for 2021 are about $25 billion in Europe and $90 to $110 billion in the U.S. The pipeline for resets and refinancing is also strong this year, with many of the 2018 and 2019 deals now out of their non-call period and looking to benefit from tighter spreads. Many of the deals issued last year with a shorter call period will also be called up later this year. Deutsche Bank estimates as high as $78 billion in refinancing and $115 billion in recess, but so far in Europe, we've already had ten managers announce that they're exploring refinancing some of the European deals.

All in all, we expect another interesting year ahead as we see how the market adjusts to the Volcker changes and increased deal documentation and flexibility. Will we see high levels of manager consolidation, and what impact will the new policies of the Biden administration have? As often noted, the only certainty is uncertainty, and this year will be no different. Overall, however, the outlook from market participants is positive as we put the challenges of 2020 behind us and anticipate an increased issuance in the year ahead. Thank you.

BRUCE BOYD: Hi, thank you for joining. My name is Bruce Boyd, I'm a senior transaction manager with the Bank of New York Mellon. Sorry about my COVID hair. Anyway, I started in this business back in February of 1989 when the first CBO closed with Kidder Peabody, it was the first CBO that was brought to market at that time. In the following 30 years or so, the markets have changed and have gone on to loans and many complex transactions. There's been quite a few challenges that we've had over those years, and yet the market still continues to thrive. Prior to the 2007 crash, those transactions, well at least in the early days, started off to be just sort of cash flow CBOs and CLOs.

They started moving around the 2000 year to more complex structures with synthetics, market value deals, just CBO squared, there was a whole bunch of different things. They had all sorts of swaps and so forth and involved, and so they got pretty complex, but the crash took care of that, and after a couple years of being dormant after this crash, the transactions went back to more or less being the simple cash flow transactions which were, at that point, were all CLOs, all loan transactions.

New regulatory requirements came out, primarily for transparency, the 17G5 reporting that put rating agencies all sort of on an equal level, they all have equal access to all the transactions. The 5% retention was added in so that collateral managers had to invest in their own transactions up to 5%, and on the European side, we saw more reporting as well, ESMA, as they call it, which is significant reporting requirements for the investors, and actually, we started seeing some talk about, even for our U.S. deals now, where we have to comply with some of the ESMA reporting as well, if there's going to be European investors in the transaction.

Most recently, we've seen, because of the LIBOR crisis, we've seen changes in the documents to allow for alternative rate language, that sort of being referred to as a benchmark so that when LIBOR goes away, which looks like it'll be another year or so, there's going to be language that we have to amend the transactions to account for what the new rate is, but it's already sort of taken being consumed in all the documents at this point. We're also seeing some relaxation in the Volcker requirements so that this component of bonds that are now allowed in the CLOs, and we're also seeing 5% retention being relaxed.

Over on the European side, of course, now with Brexit, there's additional sort of compliance that they're working out, that they're either going to be dual compliant or just EU compliant, and dual, of course, being UK and EU will have their regulatory requirements. I think we were assuming that their regulatory requirement would be on the dual compliance side. With respect to the most recent activity, we're seeing in amendments as well as language for new transactions, with respect to loan workouts, there's a contribution restructuring, or restructures that are being added into the documents to allow for the sub note holders and possibly third-party investors to put money into the transactions, so they inject cash into the CLO, into specific accounts, and then the CLO is able to participate into the loan workout. The CLO benefits because of the increased value from being able to inject money into the loan workout as well as being in a high priority, or a higher priority in those workout provisions. The funds that are used to inject into the loan workout, any benefit or economic benefit coming back from that in the way of principal interest or dividends on any equity distribution, they pass through directly to the contributing holder. They're not allocated to the CLO, it goes directly to the holders who injected the funds, so there's obviously an economic benefit to being offered the opportunity to put money into a loan workout so that they can achieve the value of coming back from this workout provision as well as the sub note holders, at the end of the day, when the transaction is terminated or redeemed, they're at the bottom of the waterfall, and so any increased value that comes up from these loans that they've helped contribute to will filter down to them so they actually have another benefit at the end of the day.

So as you can see, we've had quite a few changes, especially over the post-2007-2008 crash. And more recently, we've seen all of these things with LIBOR, the market constantly changes, and we are always adapting from a trustee side as well as the arrangers and the investors, the rating agencies, everybody is moving along to adapt to the situation at hand. It's obviously challenging for trustees at times to navigate through this. We're very optimistic with the way that the market is going overall. Stability for loan transactions is very good, and so we are being very optimistic to the CLO market at hand. So that's it. Thank you very much for joining.

JOSEPH COUDRIET: I'm Joe Coudriet, loan market digital lead at BNY Mellon. 2020 catalyzed digital trends in the syndicated loan market. Data and transparency were important going into 2020, but these seismic changes of last year have made them essential, driving us to push forward with our digital strategy in 2021. We're positioning ourselves for the acceleration of digital transformation. We see that building momentum in the latter half of 2021.

For the last few years, we've made investments in our core loans platform, and we continue to migrate clients to these platforms so that they can benefit from the improvements that we see: faster access to their information. We've seen a positive value for clients in providing data via LoanArc[SM]. We continue to develop and roll out LoanArc, which provides transparency into your portfolios and access to reporting. LoanArc puts meaningful loan data, loan portfolio data, in the hands of CLO managers, and that's going to be the theme for its ongoing development: putting as much meaningful loan and loan portfolio data on demand, giving you the freedom to access your data when you need it. We also have ISO compliant APIs to help connect data to your systems. We think LoanArc, all in all, helps you make informed decisions, managing risk, which is going to be essential in the post-COVID world. That data concept, the future of data, we continue to make investments in the future of data.

As we said earlier, I expect to see an acceleration of industry trends towards digitization, towards transparency that helps managers manage risk for decision making, for meaningful analytics towards things like open architecture and new technologies like distributed ledger technologies to solve the challenges of this market in new ways. We see it, center to all that are partnerships. We see collaboration and partnerships as key, and we're actively seeking partners and collaborators to help bring transparency to CLO managers.

For example, last year, we sponsored a hackathon to look at challenges in this market. We see those partnerships as critical. Client experience, however, is at the center of our digital strategy also, and we see clients as the most important partners that we have. Client experience is at the center of our go-forward strategy, and we consider clients active in the design process; as we build partnerships and new capabilities, we expect to do so in consultation with CLO managers, aligning our digital roadmaps to the needs that CLO managers have as we all experience the post-COVID market.

Ongoing investment in CLOs and loans are integral to BNY Mellon's strategy. We will continue implementing core investments in our loan platforms. At the same time, we're seeking ways to partner with stakeholders across the industry, data partners, industry leaders, innovation leaders, to see new ideas come to fruition, and all the while, we plan to invest time working together with you, our clients, to design new offerings to meet the needs of the future.

MAGNUS WILSON-WEBB: There's clearly a lot of activity in the CLO market at the moment. It's good to see the additional flexibility being built into new deals to allow them to participate in workout and loss mitigation loans. ESMA reporting is obviously a hot topic, we're expecting a smoother process for all market participants as we enter the second reporting cycle, and lastly, the focus on digitizing the loan market has never been more important than in this new environment. So thank you again to our contributors, and thank you to you for tuning in.